(7)

No. 90-659

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

KEITH R. GOLLUST, PAUL E. TIERNEY, JR., AUGUSTUS K. OLIVER, GOLLUST, TIERNEY AND OLIVER, GOLLUST & TIERNEY, INC., CONISTON PARTNERS, CONISTON INSTITUTIONAL INVESTORS, BAKER STREET PARTNERS, WJB ASSOCIATES and HELSTON INVESTMENT INC.,

Petitioners,

—v.—

IRA L. MENDELL, in behalf of Viacom Inc. and, alternatively, Viacom International Inc., VIACOM INC. and VIACOM INTERNATIONAL INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

The principal argument in the brief for the Securities and Exchange Commission in support of Respondent ("SEC Br.") is that the standing requirement of Section 16(b) is applicable only at the instant the plaintiff brings suit and, therefore, post-suit events, such as corporate mergers, by which a plaintiff ceases to own securities of the issuer do not cause a plaintiff to lose standing. This argument is directly contrary to all judicial precedent prior to the decision of the Court of Appeals in this case.[1] Indeed, it was not even made by the Commission in its brief to the Court of Appeals below or in its attempted rulemaking in this area. Moreover, even when advancing this argument, the Commission concedes that "some" mergers will cause a plaintiff to lose standing. The Commission does not, however, offer meaningful guidance to distinguish between those transactions that will cause the plaintiff to lose standing and those that will not. In fact, any such distinctions would be arbitrary, would be inconsistent with the statutory language and would serve no statutory purpose.

Respondent's position is even more elusive. He urges the Court to adopt a "broad and flexible interpretation" of the statute's standing requirement, to disregard "corporate form," including the separate existence of different corporate entities, in favor of "substance," and, if these arguments are insufficient, to treat his suit as a "double derivative" action so that he may sidestep Section 16(b)'s standing requirement entirely.

The Commission's and Respondent's arguments are unpersuasive. The Court should reject their invitation to rewrite the statute, and instead should apply it as it is written and hold that, since Respondent ceased to be "the owner of any

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1 *See Rothenberg v. United Brands Co.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,045, at 91,691-92 (S.D.N.Y. May 11, 1977), *aff'd mem.*, 573 F.2d 1295 (2d Cir. 1977); *Portnoy v. Kawecki Berylco Indus., Inc.*, 607 F.2d 76[illegible], 767 (7th Cir. 1979); *Staffin v. Greenberg*, 509 F. Supp. 825, 840 (E.D. Pa. 1981), *aff'd on other grounds*, 672 F.2d 1196 (3d Cir. 1982).

security of the issuer," as required by the statute, he no longer has standing to maintain this action.

A. The Commission's New Approach To Standing, Like Respondent's, Lacks Any Articulable Rationale And Is Contrary To Legislative Intent As Well As The Language Of The Statute

Before the Court of Appeals below, the Commission argued that the language of the statute—"owner of any security of the issuer"—was broad enough to include a "former" owner. *See* Brief for the Securities and Exchange Commission, *amicus curiae*, at 3, 10-11, 15-16, 19-20, *Mendell v. Gollust*, 909 F.2d 724 (2d Cir. 1990) (No. 89-7068) ("SEC Br. *Ct. of App.*"). That argument was accepted by the Court of Appeals majority as a principal basis for its decision in this case. *See* 909 F.2d at 729-30; 14a-15a. Now before this Court, the Commission abandons this argument in favor of an entirely new one: because the statute states that a Section 16(b) action "may be instituted" by the owner of any security of the issuer, the plaintiff's status becomes irrelevant the instant after the action is commenced. SEC Br. at 5-6, 7, 8-12.

Under the Commission's new theory, a plaintiff could dispose of the securities that qualified him to sue immediately after bringing the suit and nevertheless continue to prosecute the action.[2] This is an obvious distortion of the statute. It would have been pointless for Congress to have required the plaintiff to be a security owner of the issuer in the first place if it intended that he be permitted to sell his securities the instant after bringing suit. This illogical result is hardly com-

2 Although the Commission addresses its argument to mergers, in which the security owner is divested of his securities by corporate action, the argument it makes would apply equally to instances in which the plaintiff disposes of the securities in the absence of corporate action, such as in sales into the market or pursuant to tender or exchange offers, including those that may precede a second step merger. *But see* note 7, *infra*.

pelled by the use of the word "instituted."[3] *Cf. Lewis v. Anderson*, 477 A.2d 1040, 1045-46 (Del. 1984) (rejecting similar interpretation of Delaware statute governing "any derivative suit instituted by a stockholder").

The Commission's new theory of Section 16(b) standing, moreover, is every bit as artificial as its earlier one, and like Respondent's, equally contrary to Congress's intent in enacting Section 16(b)'s carefully circumscribed standing provision.

1. The Commission's Position, Like Respondent's, Requires The Federal Courts To Engage In Wholly Arbitrary Judicial Lawmaking Divorced From Legislative Guidance

a. Neither the Commission nor Respondent offers any defining rationale. Before the Court of Appeals below, the Commission argued that it was irrelevant for standing purposes when a Section 16(b) plaintiff owned his securities or whether such a plaintiff maintained an economic stake in the outcome of the suit.[4] Now before this Court, the Commission for the first time claims that timing is everything: Respondent must be accorded standing because he met the literal terms of the statute at the time the action was "instituted," and that is all the statute requires. SEC Br. at 8-12. On the other hand, the Commission concedes that its argument is not itself to be taken literally since it acknowledges that "*some* post-

3 The Commission's reliance on 42 U.S.C. § 405(g) for its interpretation of "institute," SEC Br. at 11 n.10, actually demonstrates the weakness of its position. Although that statute states that an action can be "instituted" against certain designated officials, Congress still felt it necessary to state that an action so "instituted" could be continued after there was a change in the identity of the person occupying the office. Such a proviso would have been unnecessary under the Commission's narrow reading of the term "instituted."

4 *See* SEC Br. *Ct. of App.* at 20 ("As this brief makes clear, . . . the Commission does not believe that either of these factors—filing a lawsuit prior to the merger or ownership of the parent's shares—is a statutory requirement for Section 16(b) standing.").

merger plaintiffs might lose their standing." *Id.* at 21 (emphasis in original).[5]

Within these vague constraints, however, neither the Commission nor Respondent offers any significant guidance for determining Section 16(b) standing. Instead, they urge that Section 16(b) standing should be interpreted "in an expansive fashion," SEC Br. at 13, and "broad[ly] and flexibl[y]," Resp. Br. at 9, while refusing to articulate any rationale for deciding the difficult standing questions that are bound to arise under their approach to the statute—including this very case.

The crux of the Commission's position is its contention that the role of Congress ended when it defined the interest that was necessary for a plaintiff to commence a Section 16(b) action, and that it is for the courts to divine in each case the requirements for a plaintiff to maintain such an action after it is commenced. Rather than offer this Court guidance for this exercise in judicial lawmaking, however, the Commission and Respondent steadfastly duck the issue and assert that this Court should simply find that, whatever the standard might ultimately prove to be, it has been met here.

5 This concession alone undercuts the Commission's specious, and completely inappropriate, attempt to draw an analogy between standing under Section 16(b) and diversity jurisdiction and amount-in-controversy cases. SEC Br. at 10-11. Moreover, those cases are strictly limited to jurisdictional questions relating to the subject matter of the cases federal courts are permitted to decide, and reflect a unique policy decision that courts will not reexamine the facts supporting these elements of jurisdiction after commencement of the action. *See* 13B C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure* § 3608 (2d ed. 1984). Constitutional standing, however, together with ripeness and mootness (all of which are commonly referred to as "justiciability") is rooted in Article III's case or controversy requirement, and this Court has never held that such requirements need only be established at the commencement of the suit. *See, e.g., Rosado v. Wyman*, 397 U.S. 397, 404-05 & n.6 (1970) (distinguishing federal question jurisdiction, which is tested at the outset, from mootness, which may occur long after suit has begun, and analogizing the former to diversity jurisdiction or the amount-in-controversy requirement); *Golden v. Zwickler*, 394 U.S. 103, 108 (1969) (under declaratory judgment act suit, it was wrong for district court to assess standing based on the facts in existence when the action is initiated; proper inquiry was whether actual controversy existed at the time of the hearing).

The Commission and Respondent suggest that, in deciding the standing issue in this case, this Court should look to what they describe as the "remedial" purposes of the statute. SEC Br. at 17; Resp. Br. at 9, 18. Given their expansive view of those "remedial" purposes, however, it would be difficult to perceive why standing should be denied, under this test, in *any* case where a plaintiff ceases to own securities of the issuer.[6] Yet even the Commission does not contend, for example, that a security owner who commences a Section 16(b) action could maintain that action after voluntarily selling his shares on the open market for cash immediately after filing the complaint.[7] It is less clear what the Commission contends the result should be when a plaintiff's shares are sold pursuant to an all cash merger. In its brief, the Commission suggests that a plaintiff loses standing in that situation since he no longer would have a financial interest in the suit. *See* SEC Br. at 25. But in the Commission's 1989 Proposed Rule, the Commission would have permitted a plaintiff whose shares are surrendered in such a merger to continue to sue, and, in its brief to the Court of Appeals below, the Commission took the position that prior decisions denying standing to such plaintiffs were "incorrectly decided." *See* SEC Br. *Ct. of App.* at 3.

The Commission and Respondent say that this Court need not concern itself with deciding the impact its ruling would have on other cases or even with the criteria that would be

6 *See, e.g.*, SEC Br. at 15 ("Because it would eliminate the favored class of persons on which Congress intended to rely for the enforcement of Section 16(b), petitioners' narrow rule of standing cannot be reconciled with the policy of the statute."); Resp. Br. at 3 ("It follows that a broad and flexible interpretation of the 16(b) [standing requirement] . . . is appropriate in order to implement the remedial purposes of 16(b) . . . .").

7 The Commission's reproposed Section 16(b) standing rule, before it was withdrawn when the Court granted *certiorari* in this case, would have permitted a plaintiff whose shares were "surrendered" due to a merger to continue suit, but it would not have permitted a plaintiff to continue suit after voluntarily selling his securities. *See Ownership Reports and Trading By Officers, Directors and Principal Stockholders*, Exchange Act Release No. 34-27148, 44 SEC Docket 526, 533 (Aug. 18, 1989) (reproposed Rule 16a-1(g)) (hereinafter, the "1989 Proposed Rule"), *quoted in* Pet. Br. at 28.

considered in deciding those cases—since, according to them, applying the "remedial" purposes of the statute is sufficient to require a finding of standing here. But given their complete inability to articulate a rational basis on which these cases are to be decided—not to mention the shifting, and conflicting, positions the Commission has taken in this case and in its proposed rulemaking—how can the courts possibly be expected to do so? How, for example, would this Court, under the Commission's (or Respondent's) reasoning, decide the standing issue in the following cases (in each of which a publicly owned issuer becomes a wholly owned subsidiary of an acquiring corporation pursuant to a merger):

(i) A shareholder commences a Section 16(b) suit and then sells his shares after a proposed merger is announced.

(ii) A shareholder commences a Section 16(b) suit and then tenders his shares in a cash tender offer that is followed by a second step merger.

(iii) A shareholder commences a Section 16(b) suit and then surrenders his shares for cash pursuant to an all cash merger.

(iv) A shareholder commences a Section 16(b) suit and then surrenders his shares in exchange for shares of an acquiring corporation pursuant to an exchange offer that is followed by a second step merger.

(v) A shareholder commences a Section 16(b) suit, surrenders his shares for cash pursuant to an all cash merger and uses the cash to buy stock (or other securities) of the acquiring (parent) corporation.

(vi) A shareholder who owns stock in the issuer *and* in a corporation that proposes to acquire the issuer in an all cash merger commences a Section 16(b) suit before the merger and then sells his shares in the issuer into the market or surrenders them for cash pursuant to the merger but retains his stock in the acquiring (parent) corporation.

There is no principled basis, rooted in the "remedial" purposes of Section 16(b), to distinguish between situations in which, in response to an all cash merger proposal, the plaintiff voluntarily sells shares in the issuer into the market, tenders them pursuant to a first step tender offer, or surrenders them in the merger (cases (i)-(iii) above). Yet the Commission's 1989 Proposed Rule, continuing standing only for shareholders "required to surrender the securities due to such business combination," appears to make just such distinctions. If any such transaction results in a loss of standing (and the decided cases agree that they will in *all* such cases), is there any real basis to conclude that the transaction described in case (iv) above—an exchange offer in which the plaintiff tenders his securities in the issuer in exchange for securities of the acquiring (parent) corporation—should be treated differently, since that transaction is just as "voluntary" as the sale or tender of securities in response to a cash acquisition offer? And if a plaintiff's acceptance of an exchange offer will terminate his standing to sue, why is the situation different than the instant case, in which the plaintiff exchanged his shares in the issuer in a merger that was approved by a vote of the shareholders?

And is there any meaningful difference between a plaintiff who, after surrendering his shares for cash pursuant to an all cash merger, then uses the cash to buy the acquiring (parent) corporation's stock—as in case (v) above—and one who exchanges his shares in the issuer for the acquiring corporation's stock in the merger itself—as in the instant case? Apparently the Commission thinks so, because it suggests in its brief that a plaintiff loses standing if the merger is entirely for cash, SEC Br. at 25, but does not if the merger is in part for stock as in the instant case. But so far as the "remedial" purposes of Section 16(b) are concerned, there is no more (or less) reason to permit a plaintiff to maintain a Section 16(b) suit in one such case than in the other.[8] Similarly, there is no

8 The Commission's distinction between an all cash merger and a merger in which stock is issued is that in the latter case the plaintiff "retains a financial interest in the action similar to what he held at the outset of suit."

basis to distinguish between the facts in case (vi) above—in which the plaintiff owned securities in both the issuer *and* its acquiring corporation before an all cash merger and seeks to continue the suit after the merger—and those in the instant case. But the Seventh Circuit squarely held on those very facts that the plaintiff lost standing to sue. *Portnoy v. Kawecki Berylco Indus., Inc.*, 607 F.2d 765 (7th Cir. 1979).[9]

Moreover, contrary to the arguments of the Commission (and Respondent) in this Court, no "remedial" purpose is served by distinguishing between former security owners who sue before a merger and those who bring suit after the merger is effected, or between those post-merger parent corporation shareholders who once held shares in the acquired "issuer" corporation and those that did not. In its brief to the Court of Appeals below, the Commission explicitly acknowledged the similarity to each other and to the instant case of several prior court decisions in which standing was denied to plaintiffs who sued before a merger as shareholders

SEC Br. at 25. In the instant case, Respondent can hardly be said to have retained a financial interest similar to what he held before the merger since most of the consideration for his stock was cash and the public shareholders, who owned over 80% of the issuer before the merger, received less than 18% of the common stock of its new parent in the merger. *See* JA 11, 18. Moreover, the Commission's argument that the Respondent retains a financial interest in this litigation through his stock in Viacom is flatly inconsistent with the rule recently adopted by the Commission under Section 16 which states that a shareholder "shall not be deemed to have a pecuniary interest" in the securities held by a corporation unless the shareholder controls that corporation. *See Ownership Reports and Trading By Officers, Directors and Principal Stockholders*, Exchange Act Release No. 34-28869, 48 SEC Docket 216, 256, 257 (Feb. 8, 1991) (newly adopted Rules 16a-1(a)(2)(iii), 16a-l(g), to be codified at 17 C.F.R. §§ 240.16a-1(a)(2)(iii), 240.16a-1(g)).

9 It is no doubt because of the Commission's inability to offer any meaningful distinction between the instant case and *Portnoy* that it seeks to attack the force of *Portnoy* as a precedent. *See* SEC Br. at 25 n.28. No fair reading of the opinion in *Portnoy* would support the Commission's suggestion that the court in that case did not decide that the plaintiff lost standing to sue when he lost his shares in the issuer upon its merger with the acquiring corporation. *See Portnoy*, 607 F.2d at 767 ("However, he lost that status five days later, *and consequently, we are of the opinion that* he lost the standing that he had as an owner of KBI stock." (emphasis added)).

of the issuer,[10] to a plaintiff who was both a post-merger parent corporation shareholder and a prior shareholder of the issuer,[11] and to plaintiffs who were never shareholders of the issuer and who sued after the merger.[12] SEC Br. *Ct. of App.* at 3, 14-15. The Commission was correct in that acknowledgment in the court below: there *is* no meaningful difference between these cases, and the Commission's attempt now to portray them otherwise is not well grounded.[13]

b. The Commission's and Respondent's position ignores the standing requirement expressly adopted by Congress in Section 16(b). It is thus clear that the Commission's and Respondent's appeals to the "remedial" purposes of Section 16(b) provide no useful guide for distinguishing among former shareholders who may maintain a Section 16(b) action. It is equally clear that their suggestions have nothing to do with the language of the statute itself—which specifically addresses in unmistakable terms the kind of interest a Section 16(b) plaintiff is to have in the outcome of the litigation: ownership of securities *of the issuer*.

Even when filling in the interstices of federal statutory schemes, this Court has always insisted on using as its primary touchstone the intent of Congress as evidenced by the language of the statute at issue. As stated in *Pinter v. Dahl*, 486 U.S. 622, 653 (1988):

10 *See* cases cited note 1, *supra*.

11 *See Portnoy v. Kawecki Berylco Indus., Inc., supra*.

12 *See Lewis v. McAdam*, 762 F.2d 800 (9th Cir. 1985) (per curiam); *Untermeyer v. Valhi, Inc.*, 665 F. Supp. 297 (S.D.N.Y. 1987), *aff'd mem.*, 841 F.2d 1117 (2d Cir.), *aff'd on reh'g*, 841 F.2d 25 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988).

13 The Commission's and Respondent's heavy reliance on the sole exception to this uniform body of precedent, *Blau v. Oppenheim*, 250 F. Supp. 881 (S.D.N.Y. 1966), *see* SEC Br. at 12 n.11, 25 n.27; Resp. Br. at 4, 11-16, is extraordinary in light of the weakness of the reasoning of that decision, the unanimity with which that decision has been criticized outside the Second Circuit and limited within it, and the inconsistency between that decision and the reasoning of the Court of Appeals majority below. *See* Pet. Br. at 37-38 n 18.

> [T]he Court has recognized that Congress had "broad remedial goals" in enacting the securities laws and providing civil remedies. . . . But the Court never has conducted its analysis entirely apart from the statutory language. "The ultimate question is one of congressional intent, not one of whether this Court thinks it can improve upon the statutory scheme that Congress enacted into law." The ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section. The broad remedial goals of the Securities Act are insufficient justification for interpreting a specific provision " 'more broadly than its language and the statutory scheme reasonably permit.' "

(citations omitted).

This approach has been applied to issues of standing under the federal securities laws. For example, in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 (1975), this Court rejected arguments by the Commission for an expansive interpretation of standing to bring an implied action under Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), insisting that standing be tied to the language of the statute.[14]

Blue Chip Stamps addressed the issue of standing to bring an implied right of action, where Congress had not thought at all about the issue of standing. It would be anomalous for this Court to have paid so much attention to the wording of the statute in deciding the limits on standing in that case, where Congress had not addressed standing at all, and to disregard the clear expression of intent embodied in the language of the statute here, where Congress addressed the standing question in unmistakable terms. The Commission's proposal—which now apparently requires strict adherence to

14 In *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977), the Court rejected the Commission's effort to expand standing to a competing tender offeror to bring an action under Section 14(e) of the Exchange Act, 15 U.S.C. § 78n(e), although the analysis rested on the legislative history rather than the language of the statute since Section 14(e) does not contain limiting language.

the language of the statute but only at the moment the action is "instituted," and then completely ignores that language the moment after—truly exalts form over substance, and its effort to expand standing beyond the scope called for by the language of the statute is every bit as unjustified here as in *Blue Chip Stamps*.

c. The Commission's and Respondent's arguments are not supported by the legislative history. The Commission's brief is virtually devoid of references to the legislative history of the statute.[15] Instead, it relies on the "purposes and background" of Section 16(b) for its argument that Congress intended post-commencement standing to be interpreted as broadly as possible.[16]

15 Respondent cites no legislative history to support his appeal for a "broad and flexible interpretation" of the statutory language. The only legislative history the Commission relies upon consists of citations in support of the uncontroversial proposition that "Congress framed Section 16(b) as a 'flat rule' to prevent the exploitation of inside information by the designated insiders," SEC Br. at 8, and in support of the proposition that Section 16(b) was based on, among other things, "concern for the integrity of the securities markets," *id.* at 13.

The Commission seeks to denigrate the force of the legislative history cited by Petitioners, Pet. Br. at 16, on the spurious grounds that (1) the legislative history was "taken out of context" since the precise provision that was at issue was ultimately removed from the statute, and (2) the spokesman for the drafters of the statute quoted by Petitioners "referred only to 'stockholder' plaintiffs, while Section 16(b) allows suits by bondholders, warrant holders, and other security holders." SEC Br. at 17. The Commission neglects to point out, however, that while the particular provision that was at issue was ultimately removed prior to passage of the statute, the enforcement scheme it contained which was being explained by Thomas Corcoran, *see* H.R. 7852, 73d Cong., 2d Sess. § 15(b)(3), was virtually identical to the enforcement scheme ultimately provided in Section 16(b) as enacted. Moreover, Corcoran's reference to suits by "stockholders" under this provision simply reflects a common way in which Section 16(b) suits are characterized. *See, e.g.*, SEC Br. *Ct. of App.* at 10, 18 (referring repeatedly to suits by security holders under Section 16(b) as suits by "shareholders").

16 Although the Commission's "purposes and background" arguments ultimately prove to be empty, this Court has repeatedly noted that where the language and legislative history of the statute are clear, there is no need to consider the purported "policy" behind the statute. *See, e.g.*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.33 (1976); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977); *Aaron v. SEC*, 446 U.S. 680, 695 (1980); *Randall v. Loftsgaarden*, 478 U.S. 647, 656 (1986).

The Commission's argument that standing must be read as broadly as possible because the statute only permits issuers and security holders, not the Commission, to sue makes no sense. If Congress had wanted to "cast as wide a net as possible," as the Commission hypothesizes (SEC Br. at 15), it certainly could have done so more easily than through the use of the narrow phrase "the issuer, or . . . the owner of any security of the issuer." The simple addition of the words "present or former" before "owner of any security," or a broader definition of the term "issuer" to include its parent corporation or other controlling persons,[17] would have done it. But Congress deliberately chose not to do so, just as it chose not to give the Commission the same enforcement authority under Section 16(b) that it has with respect to virtually every other provision of the federal securities laws. *See* Pet. Br. at 17 n.7. There is no basis for the Commission to argue that the absence of Commission enforcement authority evidences an intention to *expand* the persons entitled to enforce the statute.

Similarly, the Commission's argument that permitting mergers to terminate a plaintiff's standing will undercut the enforcement scheme of the statute is not only without foundation,[18] but it does not support a deviation from the standing requirements carefully considered by Congress. The Commission's policy argument applies as well to standing at

17 The term "issuer" is defined in Section 3(a)(8) of the Exchange Act, 15 U.S.C. § 78c(a)(8), to mean "any person who issues or proposes to issue any security." Where Congress wanted that term to include control persons, such as the parent corporation of the issuer, it knew how to say so. *See* Securities Act of 1933, § 2(11), 15 U.S.C. § 77b(11) (providing that, for purposes of the definition of "underwriter," the term "issuer shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer").

18 The Commission asserts that the enforcement scheme will be undermined because acquiring corporations will not sue former insiders of the acquired issuer following a merger. Not only is this contradicted by the two post-merger Section 16(b) cases to reach this Court, *see* Pet. Br. at 32, but the Commission makes no empirical showing to support its contention. *See* 5 L. Loss, *Securities Regulation* at 3012 (2d ed. Supp. 1969) ("Increasingly companies seem to be bringing their own suits.").

the commencement of the suit as it does to standing thereafter. Moreover, the principal evidence relied upon by the Commission to support this policy argument consists of a view expressed in 1987 by a subcommittee of the ABA's Committee on Federal Regulation of Securities. SEC Br. at 16. In citing this statement, however, the Commission ignores the more recent—and quite different—views expressed by the ABA Committee on Federal Regulation of Securities in addressing the Commission's Section 16 rule proposals.[19] In commenting on the initial rule proposals (described in Pet. Br. at 27-28), the ABA letter stated:

> We believe the proposed definition, even in its more narrow form, to be unsound in law and in policy. It is now settled law, as the Release itself notes, that former shareholders are not "owners" entitled to maintain an action under the statute. . . .
>
> From a policy perspective, we believe the proposed interpretation to be unsound. The function of the "owner" requirement of Section 16(b), *properly* including the plaintiff who purchases after the violation, is simply to ensure that the plaintiff has an economic interest in the litigation. To eliminate that nexus would be to recognize that the only interested party to the litigation is the lawyer who brings the action. *We believe this is a jurisprudentially unsound approach, even in the context in which the plaintiff has some continuing interest in the parent entity.* If the directly interested shareholder, who would benefit from the recovery, does not choose to bring the action, the Commission should not be seeking means by which lawyers can commence such actions without a directly interested client.

Letter from James H. Cheek, III, Chairman, ABA Committee on Federal Regulation of Securities, to Jonathan G. Katz,

19 For the Court's convenience, copies of the ABA's comment letters, which were part of the administrative record in the Commission's rulemaking proceeding and are on file with the Commission, are being lodged with the Clerk of the Court.

Secretary, Securities and Exchange Commission, dated March 13, 1989, at 20 (second emphasis added).[20]

2. Shareholder Derivative Action Principles Are Pertinent

The Commission and Respondent argue that principles applicable to shareholder derivative actions brought to enforce rights of corporations—which require a plaintiff to own the corporation's securities throughout the litigation—do not apply to Section 16(b) actions because such actions are not to be viewed as "derivative." SEC Br. at 18-20; Resp. Br. at 6-8.

Contrary to their position, Section 16(b) actions fall squarely within the definition provided by this Court in *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 529 (1984): "[T]he term 'derivative action,' which defines the scope of [Fed. R. Civ. P.] 23.1, has long been understood to apply only to those actions in which the right claimed by the shareholder is one the corporation could itself have enforced in court." The Commission seeks to escape this by asserting that Congress intended Section 16(b) actions to be enforced "primarily" by security holders. This assertion, however, flies in the face of the statute itself, which permits security holders to sue *only* if the issuer refuses to do so after demand[21] or fails diligently to prosecute the action. Had Congress truly meant Section 16(b) to be enforced primarily by security holders, it would have eliminated standing for issuers altogether, as it did in Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b)—the statute at issue in *Daily Income Fund*.[22]

20 Similar views were expressed by the ABA committee in commenting later that same year on the Commission's 1989 Proposed Rule. *See* Letter from James H. Cheek, III, Chairman, ABA Committee on Federal Regulation of Securities, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated October 31, 1989, at 12.

21 *See* Brief for the Securities and Exchange Commission, *amicus curiae*, at 9, *Kamen v. Kemper Financial Services, Inc.* (Sup. Ct. argued Mar. 27, 1991) (No. 90-516) ("The demand requirement is integrally tied to the character of a derivative action as the assertion of a corporate claim.").

22 The Commission's argument that a Section 16(b) action is not derivative because it may be brought by any *security* holder, rather than just *share*holders, SEC Br. at 19, is also inconsistent with *Daily Income Fund*. The statutory provision at issue there also granted standing to any "security holder," rather than just shareholders, to bring an action against certain fiduciaries, but the sole ground for the Court's decision that such actions were not derivative actions subject to Fed. R. Civ. P. 23.1 was that, unlike Section 16(b), they could not be brought by the corporation in its own right.

The Commission is also wide of the mark in its characterization of Section 16(b) as designed to redress not a wrong to the issuer and its security holders, but a generalized public harm to the "integrity of the securities markets." SEC Br. at 13. The legislative history makes clear that Section 16(b) was enacted primarily to create a fiduciary duty on the part of corporate insiders to the corporation and its shareholders, and to prevent a perceived harm to the issuer and its investors arising from a breach of that duty. Indeed, this purpose is manifest in the very portions of the legislative history cited by the Commission (*see id.*):

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant *betrayal of their fiduciary duties* by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities.

S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934) (emphasis added). The same congressional report later stated:

> The [Exchange Act] aims to protect the interests of the public against the predatory operations of directors, officers, and principal stockholders of corporations by *preventing them from speculating in the stock of the corporations to which they owe a fiduciary duty*. . . . In the event that he realizes any profits from [short-swing trading], he is bound to account to the corporation for such profits. . . .

Id. at 68 (emphasis added).

Statements by two of the principal drafters of the Exchange Act, Thomas Corcoran and Ferdinand

Pecora,[23] virtually remove any doubt about the proper characterization of Section 16(b) claims. In testimony before Congress, Corcoran made the following explanation of the rationale for Section 16(b):

> [Section 16] [f]orbids [a corporate insider] to carry on any short-term specualtions [sic] in the stock. He cannot, with his inside information get in and out of stock within six months. If he does, the profit goes to his company. That is simply an application of an old principle of the law that if you are an agent and you profit by inside information concerning the affairs of your principal, your profits go to your principal.

Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 133 (1934). In colloquy during Senate hearings, Pecora made a similar statement:

> [Section 16(b)] is designed avowedly to prevent insiders from utilizing their position to trade for their own account and against the interest of the general body of the stockholders. The only penalty against it . . . is that he has to disgorge his profits for the benefit of all the stockholders.

Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess. 7742 (1934).

The courts have confirmed that the statute redresses a wrong to the corporation and its shareholders, rather than an injury to the public generally. *See, e.g., Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 740 (8th Cir. 1965) ("An award for profits made by an insider in a short swing transaction under § 16(b) has been characterized without exception as non-penal, remedial compensation to protect property rights of the corporation and its investors for breach of the insider's fiduciary relationship."), *cert. denied*, 382

23 The role played by these two in the passage of the legislation is described in *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 246, 250 n.24 (1976).

U.S. 987 (1966); *Adler v. Klawans*, 267 F.2d 840, 844 (2d Cir. 1959).[24]

Finally, the Commission also implies that even if Section 16(b) were considered to be a derivative action, the law governing derivative actions would not divest a plaintiff of standing in these circumstances. SEC Br. at 20. This is simply not true. Courts applying federal law have consistently held that loss of shareholder status divests a plaintiff of standing to maintain a derivative action,[25] and the same result generally applies under state law as well.[26] Although some courts have created extremely limited exceptions to the continuous ownership requirement,[27] the Commission has cited no case

24 The Commission cites general language in the legislative history of Section 16 purportedly indicating that the provision had a broad purpose of ensuring "the integrity of the securities markets," SEC Br. at 13, which would suggest it was intended to serve interests broader than just those of the issuer and its investors. Even if this additional purpose could be gleaned from the language cited by the Commission, however, the fact that Section 16(b), like all of the Exchange Act, also served broader "market integrity" interests, *see* Exchange Act § 2, 15 U.S.C. § 78b, no more justifies an open-ended expansion of standing than it did in *Blue Chip Stamps* and *Piper*.

25 *See, e.g., Lewis v. Knutson*, 699 F.2d 230 (5th Cir. 1983) (loss of standing through involuntary loss of shares through reverse share split); *Schilling v. Belcher*, 582 F.2d 995, 999-1002 (5th Cir. 1978) (under federal and Florida law, purchase of all shares of corporation by acquiring corporation after verdict favorable to plaintiff divests plaintiff of standing); *Fischer v. CF&I Steel Corp.*, 599 F. Supp. 340 (S.D.N.Y. 1984) (plaintiff loses standing to maintain derivative antitrust action through reorganization in which plaintiff's shares are exchanged for shares of new holding company); *Orenstein v. Compusamp, Inc.*, 19 Fed. R. Serv. 2d (Callaghan) 466 (S.D.N.Y. 1974) (loss of standing through voluntary sale alleged to have been fraudulently induced).

26 *See, e.g., Heit v. Tenneco, Inc.*, 319 F. Supp. 884 (D. Del. 1970) (Delaware law: loss of standing to maintain state law derivative action after merger in which plaintiff's shares were exchanged for stock of grandparent corporation); *Prudential-Bache Sec., Inc. v. Matthews*, 627 F. Supp. 622, 623-24 (S.D. Tex. 1986) (Texas law: cash-out merger divests standing both for plaintiffs who voluntarily tendered shares for cash in first step of two-step merger and for plaintiff who involuntarily lost shares in second step merger).

27 *See, e.g., Arnett v. Gerber Scientific, Inc.*, 566 F. Supp. 1270, 1273 (S.D.N.Y. 1983) (applying federal law: plaintiff does not lose standing to maintain a derivative antitrust claim where "(1) plaintiffs' disposition of the stock was involuntary; (2) the disposition was related to the allegedly illegal

that would make an exception to that requirement under the circumstances of this case.[28]

3. The Commission's And Respondent's Positions Repeatedly Exalt Form Over Substance

The Commission and Respondent each urge that a finding of standing is required in this case to avoid exalting form over substance. SEC Br. at 26 (Court should disregard merger into subsidiary of acquiring corporation as in "substance . . . identical" to merger into acquiring corporation itself); Resp. Br. at 22-25 (separate corporate entities should be disregarded). It is difficult to imagine a greater emphasis on form, however, than the Commission's contrived approach in which it claims that the statute requires a plaintiff to own securities in the issuer at the instant—but only at the instant—the suit is filed. In addition, the Commission's apparent distinctions among various types of transactions all of which result in a plaintiff ceasing to be a security owner of

acts of defendants; and (3) the remedy sought would result in plaintiffs regaining shareholder status"); *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1984) (Delaware law: stock-for-stock merger in which plaintiff becomes shareholder of new parent corporation; neither of two recognized exceptions—where merger itself is based on fraud or where merger is part of reorganization which does not affect plaintiff's ownership of the business enterprise—apply); *Kramer v. Western Pac. Indus., Inc.*, 546 A.2d 348, 354-55 (Del. 1988) (same—narrowly interpreting *Lewis v. Anderson* exceptions); *Zauber v. Murray Savings Ass'n*, 591 S.W.2d 932, 937-38 (Tex. Civ. App. 1979) (Texas law: shareholder cashed out in reverse stock split; shareholder may maintain standing if corporate action taken solely to defeat standing), *applic. for writ of error denied*, 601 S.W.2d 940 (Tex. 1980).

28 The Commission cites two cases, *Gaillard v. Natomas Co.*, 173 Cal. App. 3d 410, 219 Cal. Rptr. 74 (1985), and *Alford v. Shaw*, 327 N.C. 526, 398 S.E.2d 445 (1990), for the proposition that the continuous ownership requirement is not applied where the plaintiff's shares are exchanged for shares of the new corporate parent. SEC Br. at 20 & n.23. However, in each of these cases, the court's decision not only rested on a narrow interpretation of the particular state statutory provision governing derivative actions, *see Gaillard*, 219 Cal. Rptr. at 76-77; *Alford*, 398 S.E.2d at 449, but also emphasized that the lawsuit was itself aimed at challenging the wrongfulness of the very merger that deprived the plaintiffs of their shares, *Gaillard*, 219 Cal. Rptr. at 80; *Alford*, 398 S.E.2d at 450.

the issuer also exalt form over substance, as discussed in Part A.1, *supra*.

It is also significant that the very distinction in "form" that is so heavily criticized by the Commission and Respondent is one that has been built into the Exchange Act itself. When Congress wanted to disregard the corporate form in the securities laws, it knew how to do so. *See* note 17, *supra*.

Respondent's argument that the corporate form should be disregarded here on an "alter ego" theory is equally baseless. There is no evidence in the record that the particular form of the transaction through which Viacom acquired International, in which Petitioners played absolutely no role, was anything other than a bona fide, arm's-length transaction.[29] Indeed, if carried to its logical conclusion, Respondent's argument would sweep away the existing caselaw denying standing to shareholders of parent or grandparent corporations to bring Section 16(b) actions.[30]

Finally, the Commission itself exalts form over substance by engaging in a game of labels—claiming that this Court's well-established jurisprudence under Section 16(b), which has rejected an "expansive" interpretation of the statute—has no application here because this suit involves "standing," while this Court's prior decisions involved "liability." SEC Br. at 22-23. But the enforcement mechanism is an integral part of any statutory scheme, and Section 16(b) is no exception. Moreover, Section 16(b)'s straightforward language stating who may bring an action under it—"the issuer, or . . . the owner of any security of the issuer"—is plainly cut from the same mold as the straightforward language governing liability.

29 The two cases, each well over 50 years old, relied on by Respondent for the proposition that the corporate form may be readily disregarded in the name of "public policy" are inapposite. These cases involved efforts by shareholders of corporations to limit their liability for injuries caused by the corporation. Whatever vitality they may still have beyond their particular facts, they can have no application to the question of who has been authorized by Congress to bring a particular lawsuit—especially under the mechanically applied provisions of Section 16(b).

30 *See* cases cited note 12, *supra*.

B. Respondent May Not Maintain This Section 16(b) Action As A "Double Derivative" Suit

Respondent repeats his assertion, rejected by the District Court below but not addressed by the Court of Appeals—and which the Commission does not address in its brief—that he may properly bring this action as a "double derivative" action. This assertion must plainly be rejected as a subterfuge to evade the explicit standing requirements of Section 16(b). As the District Court noted in rejecting this argument:

> Section 16(b)'s standing requirements are specific, and must be strictly construed. If successful, plaintiff would enlarge the class of persons entitled to sue under § 16(b) to include shareholders of a shareholder. However, shareholders of a shareholder are not the issuer or the owners of the issuer's securities, and therefore, by the statute's own terms, they are not entitled to sue under § 16(b).

Mendell v. Gollust, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,086, at 91,087 (S.D.N.Y. Nov. 8, 1988); 33a (citation omitted). The District Court was clearly correct: Congress's *express* authorization within Section 16(b) itself of a single derivative action is inconsistent with an *implied* authorization of multiple derivative actions as well. *See Untermeyer v. Valhi, Inc.*, 665 F. Supp. 297, 299 (S.D.N.Y. 1987) ("The validity of multiple derivative suits in other contexts does not justify circumvention of section 16(b)'s specific standing requirements." (citations omitted)), *aff'd mem.*, 841 F.2d 1117 (2d Cir.), *aff'd on reh'g*, 841 F.2d 25 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988).

CONCLUSION

The judgment of the Court of Appeals should be reversed, and the case should be remanded to the Court of Appeals with directions to affirm the order appealed from.

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